United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

Signed

76-4020

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

W. LEE KNIGHT and EVELYN KNIGHT,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION

OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

B
P/S

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CITATIONS

IN THE UNITED STATES COURT OF APPEALS

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STATEMENT OF THE ISSUE PRESENTED

Debts taxpayers were owed by their closely held corporation became worthless in 1968. The question is whether the Tax Court properly found that the debts were not created in connection with a trade or business of the taxpayers, and thus that they are nonbusiness bad debts under Section 166(d) of the Internal Revenue Code of 1954, rather than fully deductible business debts.

STATEMENT OF THE CASE

This is an appeal from the decision (R. 15)[1/] of the United States Tax Court (Honorable Arnold J. Raum), entered on October 16, 1975, sustaining the Commissioner's determination of a deficiency

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1/ "R." references are to appellants' separately bound record appendix. Since appellants failed to seek the Commissioner's counter-designation of the contents of the record appendix, we have included additional materials in Appendix B herein, pp. 22-3_, for the Court's convenience. Citations to those materials will read "App. B, ."

in income tax of $8,906.81 against the Knights for the year 1968.[2/] The court's memorandum findings of fact and opinion were filed on March 25, 1975, and are reported at P-H Memo T.C., par. 75,077. Taxpayers thereafter timely filed a notice of appeal (R. 16) by depositing the same in the United States mails on January 14, 1976. This Court has jurisdiction by virtue of Section 7482 of the Internal Revenue Code of 1954.

The case was submitted on stipulation of fact and stipulated exhibits. (R. 5; App. B, pp. 22-25.) The relevant facts, as found by the Tax Court (R. 6-9) and otherwise as shown on the record, may be summarized as follows:

In December, 1956, taxpayers and Jeanne and Jacques De Mattos entered into an agreement to purchase a motel and restaurant in Lake City, Florida, known as the Holiday Motel and Holiday Restaurant. The purchase price for the real estate and personal property involved was $226,250, with payment to be made by a down payment of cash, the assumption of an outstanding mortgage and accrued brokers' fees, and the execution of a promissory note and second mortgage to the sellers. The purchase was consummated in January, 1957, and a bill of sale, warranty deed and mortgage were recorded on January 31, 1957. On February 8, 1957, taxpayers and the De Mattoses filed notice as required by

2/ The Tax Court's decision (R. 15) was that the Knights had overpaid their tax liability for 1968 by $451.50. The overpayment resulted from the fact that taxpayers paid the asserted deficiency of $8,906.81 to the Internal Revenue Service during the course of the proceedings in the Tax Court. See Respondent's Computation for Entry of Decision, included in the documents comprising the original record on appeal as prepared for transmittal to this Court by the clerk of the Tax Court.

Florida law that they were engaged in business under the fictitious name "Holiday Motel and Holiday Restaurant." The notice stated that each of the four persons had a 25 percent interest in the business. (R. 6, 17-23, 26-27.)

A Florida corporation was later organized to operate the motel and restaurant. A certificate of incorporation for "Dak Company, Inc." was filed in April, 1957. The corporation was authorized to issue 100 shares of common stock, and the Knights and the De Mattoses each purchased 50 shares for $17,500. The same persons[3/] were elected as the directors and officers of the corporation, with W. Lee and Evelyn Knight serving as president and secretary, respectively. (R. 6-7, 28; App. B, pp. 23-24, pars. 5-7.)

At its initial meeting in May, 1957, the board of directors of Dak agreed to purchase the motel and restaurant property from the shareholders on behalf of the corporation. The purchase price was set at $225,200, with $35,000 to be paid through issuance of 100 shares of Dak common stock, and $40,000 through issuance of the corporation's demand notes bearing interest at 5 percent per annum. The remainder of the purchase price was to be satisfied by Dak's assumption of the mortgages on the property and the liability for brokers' fees which the shareholders had undertaken when they purchased the property. The board of directors authorized taxpayers to execute the necessary documentation for the sale in their capacities as president and secretary of the corporation. (R. 6-7, 28-31.)

3/ Hereafter, we shall generally refer to the Knights and the De Mattoses collectively as "the shareholders."

However, record title to the real and personal property was never conveyed to Dak. The shareholders remained the owners of record until November, 1968, when they conveyed the property to unrelated third parties. Nevertheless, Dak operated the business from the time of its formation until the 1968 sale, and both the real and personal property used in the business was listed among the corporation's assets in its annual financial statements for all but one of the years from 1957 until 1967.[4/] The mortgages on the property were shown as corporate liabilities on those statements, and depreciation, taxes, interest, and repairs and maintenance were listed as corporate expenses. Likewise, the financial statement for the year ending December 31, 1968 reflected the sale of the business property that had occurred in November of that year: the property was no longer included in the corporation's assets, and a loss on the sale of real and personal property was shown on the statement of profit and loss. (R. 7; App. B, pp. 26-36.)

Dak suffered losses in 9 of the 11 years from 1957 through 1968 that it operated the business. During that time, the shareholders made a number of loans to the corporation. The Knights and the De Mattoses each advanced one-half of all the loans, which (together with repayments from the corporation) were made as follows:

4/ The record does not contain a financial statement for the year ending December 31, 1966. (R. 8.)

Year	Loan	Repayment	Balance as of December 31
1957	$40,000.00	$18,896.00	$21,104.00
1958	12,147.24	221.37	33,029.87
1959	---	---	33,029.87
1960	---	---	33,029.87
1961	---	---	33,029.87
1962	---	---	33,029.87
1963	---	---	33,029.87
1964	2,900.00	---	35,929.87
1965	---	800.00	35,129.87
1966	---	200.00	34,929.87
1967	2,211.51	---	37,141.38
1968	---	500.00	36,641.38
TOTAL	$57,258.75	$20,617.37	

Interest on the loans was accrued as a liability on the corporation's financial statements. (R. 8-9; App. B, p. 27.)

In February, 1958, the board of directors voted to pay W. Lee Knight and Jacques De Mattos $5,000 each for services rendered in 1957, and Knight and De Mattos agreed to loan identical amounts back to the corporation. No other salaries were ever authorized for the officers or directors of the corporation, nor do its financial statements reflect that such payments were made for any year other than 1957.[5/] The corporation ceased operations when the business property was sold in 1968, and was finally dissolved in 1969. (R. 8, 9; App. B, p. 25.)

Taxpayers deducted their share of the unpaid balance of the loans made to Dak as worthless debts on their 1968 return. They asserted that the losses constituted business bad debts because the loans had been made to protect their positions as officers

5/ The financial statements do indicate that Dak expended varying amounts from 1957 through 1964 for "officers' life insurance" (R. 8), but the record does not reveal the identity of the owners or beneficiaries of any policies of insurance.

and employees of the corporation, and, alternatively, because the motel and restaurant had been operated as a joint venture by Dak and its shareholders, so that the loans were made to Dak in the course of carrying on the trade or business of the joint venture.

The Tax Court agreed with the Commissioner's assertions to the contrary.[6/] The court concluded that no joint venture had existed between Dak and its shareholders, and that Dak alone was engaged in the business of operating the motel and restaurant. The court also found taxpayers had failed to establish that the loans were made to protect their positions as officers and employees of the corporation. (R. 10-14.) Taxpayers appeal.

6/ The Commissioner did stipulate that the debts had become worthless in 1968, and that the amount of the resulting loss was $18,320.69. (App. B, p. 25.) The parties had earlier disagreed on both these points. See taxpayers' petition to the Tax Court, and the Commissioner's notice of deficiency, included in the original record on appeal.

SUMMARY OF ARGUMENT

The issue here is whether taxpayers' bad debt losses shall be characterized as business bad debts, and thus be fully deductible from ordinary income, or as nonbusiness bad debts, which are deductible under the more restrictive provisions for short-term capital losses. In order to receive the more favorable treatment reserved for business bad debts, taxpayers must establish that their loans to Dak were "proximately related" to their trade or business.

To do so, taxpayers contend that Dak and its shareholders engaged in a partnership to operate the motel and restaurant, that partners are considered to be engaged in the trade or business of the partnership, and that the loans to Dak were therefore incurred in connection with their trade or business. But there is no evidence of record which suggests that such a partnership was intended. None of the indicia which this Court has used to determine the existence of a partnership is present here. There is no agreement to form a partnership among the shareholders and Dak, nor is there any evidence that Dak and its shareholders held themselves out as partners or as joint venturers to third parties.

Moreover, the shareholders made no contribution of property or services to the purported venture. Taxpayers contend that the shareholders retained ownership of the business property and contributed its use to the enterprise, but the record reveals that they agreed to sell the property to Dak shortly after its formation, and that Dak assumed the benefits and burdens of ownership of the property until it was sold to outsiders in 1968.

The profits and losses of the business were treated as Dak's alone, and the shareholders participated in the enterprise only in their capacities as representatives and owners of the corporation. Thus, far from maintaining the mutual relationship with Dak that would have indicated the existence of a partnership or joint venture, the evidence reveals that the shareholders purchased the motel and restaurant and conveyed it in toto to their newly formed corporation.

Taxpayers also contend that their losses are business bad debts because the dominant motivation for their loans was the protection of their positions as salaried executives of Dak. Again, however, the record supports no such theory. Taxpayers received only $5,000 in pre-tax salary throughout Dak's existence, and there is nothing to suggest that they were owed anything more by the corporation.

Moreover, there is no evidence that that meagre salary governed taxpayers' motivations for loans of more than $28,000 to Dak. Since the $5,000 in salary was paid in only one year, it cannot be concluded that taxpayers were dependent on their jobs with Dak for their livelihood. And since they were co-owners of the corporation's stock, it can hardly be thought that the loans were necessary to maintain their employment. Taxpayers have thus failed to establish that the dominant motivation for their loans concerned their status as employees of Dak, and not their interests as investors in the corporation.

Thus, the Tax Court's decision that taxpayers' losses are nonbusiness bad debts is not clearly erroneous, and should be affirmed.

ARGUMENT

THE TAX COURT PROPERLY FOUND THAT THE DEBTS DAK COMPANY OWED TAXPAYERS WERE NONBUSINESS BAD DEBTS

The question presented on this appeal is whether the debts taxpayers were owed by Dak shall be characterized as "business" or "nonbusiness" bad debts for purposes of Section 166 of the 1954 Code, Appendix A, infra. If characterized as "business" debts, they are deductible in full from ordinary income under Section 166(a); if they are found to be "nonbusiness" bad debts, they are deductible only as short-term capital losses under Section 166(d)(1).[7/]

Section 166(d)(2) defines nonbusiness bad debts to include a debt "other than * * * [one] * * * created or acquired * * * in connection with a * * * trade or business [of the taxpayer] * * *." In order to obtain the more favorable treatment reserved for business debts that do not fall within this definition, the taxpayer must prove that the acquisition of the debt in question was proximately related to his trade or business. Treasury Regulations on Income Tax (1954 Code), § 1.166-5(b), Appendix A, infra; United States v. Generes, 405 U.S. 93 (1972); Hogue v. Commissioner, 459 F. 2d 932 (C.A. 10, 1972). The Tax Court concluded that such a relationship was not shown here, and its

7/ Short-term capital losses are deductible to the extent of the taxpayer's capital gains for the year, if any, plus up to $1,000 of ordinary income. Sec. 1211(b) of the 1954 Code (26 U.S.C.). Under Section 1212(b) of the Code [as added by Sec. 230(a), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19] (26 U.S.C.), the excess of losses not so deducted may be carried forward from year to year until exhausted.

findings are to be overturned only if determined to be "clearly erroneous." Hogue v. Commissioner, supra.

Taxpayers forward two theories to that end. They contend first that Dak and its shareholders formed a partnership or joint venture to conduct the motel and restaurant business, that the shareholders purchased the property used in that business and placed it at the disposal of Dak as their contribution to the joint venture, and that the shareholders made loans to Dak to enable it to fulfill its role as the operating partner in the enterprise. Since a partner is considered to be engaged in the trade or business of the partnership, and since the debts owed by Dak were allegedly "created * * * in connection with" the partnership's business of operating a motel and restaurant, taxpayers conclude that those debts constitute business bad debts. See taxpayers' Br. 7-13; see generally Butler v. Commissioner, 36 T.C. 1097 (1961), and authorities discussed at pp. 1106-1107 thereof. But since there is no evidence here that supports taxpayers' premise that Dak and its shareholders were joint venturers or partners, taxpayers' first theory remains just that.

A joint venture has been generally defined as--

> "a special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation," and also as "an association of persons to carry out a single business enterprise for profit."

Beck Chemical Equipment Corp. v. Commissioner, 27 T.C. 840, 848-849 (1957). Since a joint venture is considered a partnership

for income tax purposes (Sec. 761(a) of the Code, Appendix A, *infra*), the existence of either business relationship turns on a resolution of the factual inquiry as to "whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." *Commissioner* v. *Tower*, 327 U.S. 280, 287 (1946); *Commissioner* v. *Culbertson*, 337 U.S. 733, 741-742 (1949).

In *Estate of Kahn* v. *Commissioner*, 499 F. 2d 1186 (1974), this Court only recently enumerated a number of factors which indicate the existence of a partnership. The Court stated that those factors include (*ibid.*, p. 1189)--

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

None of those factors is present in this case. Dak and its shareholders did not file partnership tax returns, they did not hold themselves out to anyone as joint venturers, nor did they maintain separate books of account to reflect the joint conduct of the motel and restaurant business. Furthermore,

there is absolutely no evidence of any agreement to form a joint venture or partnership for the conduct of the business. Taxpayers contend that the shareholders' registration of fictitious names (R. 26-27) was an "original form of partnership agreement." (Br. 9.) But aside from the fact that such a registration does not necessarily reveal the business form in which an enterprise is being conducted (see Fla. Stat. Ann., § 865.09), the shareholders made the registration here before Dak was incorporated. (App. B, p. 23.) That document therefore sheds no light on the nature of the relationship between Dak and the shareholders.

The record also supports the Tax Court's conclusion (R. 14) that the shareholders made no contribution of property to the purported venture. Taxpayers contend (Br. 9) that they retained ownership of the business property and permitted it to be used in the enterprise, but the evidence indicates that beneficial ownership of the property was transferred to Dak in 1957. The shareholders agreed to sell the property to Dak in May, 1957, within a month after it had been incorporated. (R. 28-31.) The property was thereafter listed among Dak's assets in each of its annual financial statements from 1957 until 1968, the year in which the property was sold. (R. 7; but see fn. 4, p. 4, supra.)

The mortgages on the property were also treated as the corporation's liabilities on these financial statements,[8/] as

8/ In addition to its assumption of these mortgages, Dak was to issue $35,000 worth of stock and promissory notes for $40,000 to its shareholders in payment of the agreed purchase price. (R. 30.) Though the record does not expressly indicate whether

were expenses for depreciation, interest, property taxes, and repair and maintenance. (App. B, pp. 26-36.) Thus, the record fully supports the Tax Court's finding (R. 11) that Dak was the beneficial owner of the property, and that the shareholders retained only a naked legal title for the benefit of the corporation.

Moreover, the conclusion that Dak effectively purchased the property in 1957 is not shaken by the fact that only the shareholders executed a conveyance of the property when it was sold in 1968. (R. 23-24.) A conveyance from the shareholders was undoubtedly necessary in order to properly effect the sale, since Dak never appeared in the chain of title to the real property involved. But is was not necessary that Dak have acquired record title to the property in order to be considered to have owned it for federal tax purposes, since it is clear on the record that the benefits and burdens of ownership of the property passed to Dak in 1957. See Harmston v. Commissioner, 61 T.C. 216 (1973),

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8/ (continued)
These latter terms were actually complied with, $35,000 was the value placed on the stock issued by the corporation (App. B, p. 23), and $40,000 was the amount of the shareholder loans to Dak in 1957, the year in which the sale was agreed to. The stipulations of fact do state (App. B, p. 23) that Dak issued its stock in exchange for cash, but on the other hand, taxpayers suggest in their brief that the "loans" of $40,000 in 1957 actually constituted the promissory notes Dak was to issue as part payment for the sale (compare Br. 15; R. 30). Thus, since Dak assumed the benefits and burdens of ownership of the business property in all other respects, we submit that it would not be unreasonable to infer that the stock and note aspects of the sale were also carried out.

aff'd per curiam, 37 A.F.T.R. 2d, par. 76-418 (C.A. 9, 1976); cf. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).[9/]

Taxpayers also point to the shareholders' participation in the refinancing of the property in 1964 as indicating that they had retained ownership of the property. (Br. 9.) The business property was apparently refinanced in 1964 to prepay the first and second mortgages on the property, and thereby realize a 15 percent reduction in the balance of those mortgages. (See R. 19, 24; App. B, pp. 30, 33-34.) But while the shareholders executed the documentation required for this refinancing (R. 24), the discount obtained was reflected as income on Dak's financial statement for 1964, and the new mortgage on the business property was listed as its liability for 1964 and subsequent years. (App. B, pp. 33-34.) Thus, Dak both received the benefit and bore the burden of this transaction--just as it assumed possession and responsibility for the property in all other respects. The record therefore suggests that, far from contributing property to the conduct of a joint venture with Dak, the shareholders effectively sold the property to the corporation in 1957, and that it alone operated the business thereafter.

9/ Indeed, if the shareholders had retained ownership of the business property, the proceeds of the 1968 sale would have gone to them. Yet taxpayers' petition to the Tax Court alleges that the proceeds from the sale were used to repay Dak's creditors, and the results of the sale are reflected on Dak's financial statement for 1968 (App. B, pp. 33-36). We also note that a loss on a 1960 sale of fixed assets--presumably assets used in the motel and restaurant--was reflected in Dak's financial statement for that year. See pp. 2, 3 of Jt. Ex. 14-N in the original record on appeal.

It thus becomes evident that the remaining factors set forth in Estate of Kahn, supra (see p. 11, supra), are likewise absent here. Since the shareholders did not contribute any property to the enterprise, they had no proprietary interest in the profits and losses it produced.10/ Indeed, Dak's financial statements indicate that it alone received the profits and absorbed the losses of the business. Similarly, there was no mutual control over the business as between Dak and its shareholders. While the shareholders no doubt controlled the operation of the business, they did so only as representatives of the corporation--i.e., as its officers and directors--or in their individual capacities as its shareholder-owners.

As if to acknowledge that they cannot satisfy the partnership criteria set forth in Estate of Kahn, taxpayers point out that most of those factors were also absent in Stanchfield v. Commissioner, P-H Memo T.C., par. 65,305 (1965), where the Tax Court nevertheless concluded that a joint venture existed. (Br. 11-12.) But as this Court noted in Estate of Kahn, supra, p. 1189, fn. 4, no one of the partnership factors is controlling. Those factors are merely aids in the subjective inquiry whether a partnership was intended by the parties. Thus, the number of those factors present in Stanchfield is immaterial, since it was clear that a joint venture was intended by the

10/ Taxpayers make no contention that their contribution to the venture consisted of services, nor would the evidence support that contention. The shareholders acted only as representatives and owners of the corporation.

parties there. By contrast, we have demonstrated that there was no such intention here, and the Tax Court properly rejected (R. 9-10) the joint venture contention. Since taxpayers were not engaged in a partnership with Dak, the debts involved here were not created in connection with the trade or business of operating a motel and restaurant.

Taxpayers' second theory is that the debts were "created * * * in connection with" their trade or business as salaried officers and executives of Dak. Taxpayers acknowledge that because of their dual status as shareholders and employees, they must establish that the dominant motivation for their loans related to their status as employees, and not to their interests as investors in the corporation. United States v. Generes, 405 U.S. 93 (1972); cf. Whipple v. Commissioner, 373 U.S. 193, 201-203 (1963.) They contend that their motivations for making the loans to Dak satisfy that requirement. (Br. 13-17.)

On this record, however, we fail to see how. The only salary taxpayers ever received from Dak consisted of the $5,000 paid to W. Lee Knight for services rendered in 1957. (R. 12, 32.) There is no evidence that taxpayers received any other salary, nor that any salary was owed them by the corporation.[11] While it is undisputed that Knight agreed to lend his 1957 salary back to the corporation (R. 32), the record does not indicate that he did so out of a motivation to protect his position as a salaried

11/ While Dak made expenditures for "officers' life insurance" from 1957 until 1964 (see fn. 5, p. 5, supra), there is no warrant for treating those sums as additional compensation here, since there is no indication who benefited from them.

executive of the corporation. Moreover, there is absolutely no evidence that taxpayers were stirred by such motivations when they made more than $23,000 worth of additional loans to Dak.

Thus, as the Tax Court noted (R. 12), this case is quite unlike Trent v. Commissioner, 291 F. 2d 669 (C.A. 2, 1961), where the taxpayer made loans to a corporation to maintain his employment. As the Supreme Court noted in Whipple v. Commissioner, supra, p. 203, the rationale of Trent v. Commissioner can hardly apply where loans are made by a shareholder in a position to control the debtor corporation. Yet, since taxpayers were co-owners of the corporation's stock, that is exactly the situation here.

Likewise, taxpayers' reliance (Br. 14-15) on Faucher v. Commissioner, P-H Memo T.C., par. 70,217 (1970), is misplaced. In permitting business bad debt treatment in Faucher, the Tax Court expressly relied on the fact that Faucher's employment with the corporation to which he loaned funds was virtually his only source of income at the time the loan was made. By contrast, taxpayers received their $5,000 in salary from Dak in only 1 of the 11 years in which it operated the business. Cf. United States v. Generes, supra, pp. 110-111 (Marshall, J., concurring).

And since taxpayers' investment in the corporation's stock totalled $17,500, we submit that it cannot be found that they advanced over $28,000 in loans to the corporation primarily to protect jobs with the corporation which had netted them only

$5,000 in pre-tax salary. Cf. United States v. Generes, supra, pp. 106-107.[12/] The Tax Court's conclusion that taxpayers failed to show their debts were other than nonbusiness bad debts is therefore entirely proper.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APRIL, 1976.

12/ In this regard, it is not insignificant that since taxpayers received no salary after early 1958 (R. 32), they were not even engaged in the trade or business of being salaried employees when they made loans to Dak in 1964 and 1967. (R. 9.) See Whipple v. Commissioner, supra, p. 204; Commissioner v. Schaefer, 240 F. 2d 381, 384 (C.A. 2, 1957). This further indicates that taxpayers expected a return from the corporation as investors, and not as employees. Cf. Whipple v. Commissioner, supra.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 26th day of April, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

Henry Gelles, Esquire
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Gilbert E. Andrews
GILBERT E. ANDREWS,
Attorney.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * *

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * *

SEC. 761. TERMS DEFINED.

(a) Partnership.--For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. * * *

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.166-5 Nonbusiness debts.

* * *

(b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any other than--

(1) A debt which is created, or acquired, in the course of a trade or business or the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

APPENDIX B

UNITED STATES TAX COURT

W. LEE KNIGHT and EVELYN KNIGHT, Petitioners,	)	
v.	)	Docket No. 5285-71
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	[filed September 30, 1974]

STIPULATION OF FACTS

The parties hereby stipulate and agree that for the purpose of this case the following facts and exhibits attached hereto and made a part hereof may be taken as true, subject to the rights of the parties to introduce other and further evidence not inconsistent with this stipulation and preserving the parties' rights to object, at the time of trial, to any and all portions of said stipulation and attached exhibits as they may deem to be irrelevant or immaterial.

1. Petitioner W. Lee Knight and Evelyn Knight are man and wife who resided at 34 Algonquin Avenue, Saranac Lake, New York, at the time of the filing of the petition; they timely filed a joint income tax return for the taxable year 1968 with the Albany District Director, the original of which is attached hereto and marked Joint Exhibit 1-A.

2. On December 12, 1956, W. Lee Knight, Evelyn W. Knight, Jacques De Mattos and Jeanne De Mattos contracted to purchase certain property known as the Holiday Motel and Holiday Restaurant [hereinafter referred to as the premises]. The Agreement for Deed is attached hereto and marked Joint Exhibit 2-B.

3. A memorandum setting forth various transactions with regard to the premises is attached hereto and marked Joint Exhibit 3-C.

4. A Registration of Fictitious names dated February 8, 1957, is attached hereto and marked Joint Exhibit 4-D.

5. A certificate of incorporation of Dak Company, Inc. was filed in the office of the Secretary of State of the State of Florida on April 26, 1957.

6. The capital stock of Dak Company, Inc. consisted of 100 shares of common stock, 50 shares of which were issued to petitioners in exchange for cash of $17,500.00 and 50 shares of which were issued to Mr. and Mrs. Jacques De Mattos in exchange for cash of $17,500.00. There were no transfers of stock or any further issuance of stock of Dak Company, Inc. from the time of its incorporation until the time of its dissolution in October 1969. The stock certificates issued to W. Lee Knight and to Evelyn W. Knight are attached hereto and marked Joint Exhibits 5-E and 6-F, respectively.

7. The following documents are attached hereto and marked as follows:

		Joint Exhibit
A.	Waiver of Notice of Meeting of Incorporators	7-G
B.	Minutes of First Meeting of Incorporators	8-H
C.	Waiver of Notice of First Meeting of Directors	9-I
D.	Minutes of First Meeting of Directors	10-J

8. The financial statements of Dak Company, Inc. are attached hereto and marked as follows:

Calendar Year	Joint Exhibit
1957	11-K
1958	12-L
1959	13-M
1960	14-N
1961	15-O
1962	16-P
1963	17-Q
1964	18-R
1965	19-S
1967	20-T
1968	21-U

9. The Minutes of the Board of Directors of Dak Company, Inc. dated February 13, 1958, are attached hereto and marked Joint Exhibit 22-V.

10. Dak Company, Inc. had outstanding loans payable to its shareholders, one-half of which loans were payable to petitioners, as follows:

Year	Loan	Repayment	Balance as of December 31
1957	$40,000.00	$18,896.00	$21,104.00
1958	12,147.24	221.37	33,029.87
1959	---	---	33,029.87
1960	---	---	33,029.87
1961	---	---	33,029.87
1962	---	---	33,029.87
1963	---	---	33,029.87
1964	2,900.00	---	35,929.87
1965	---	800.00	35.129.87
1966	---	200.00	34,929.87
1967	2,211.51	---	37,141.38
1968	---	500.00	36,641.38

11. Petitioners incurred a bad debt in the amount of $18,320.69 in 1968.

12. Dak Company, Inc. was dissolved on October 14, 1969, with the filing of a certificate of corporate dissolution with the Secretary of State of Florida.

Henry Celles

HENRY CELLES
Counsel for Petitioners
P.O. Box 590
Lake Placid, New York

MEADE WHITAKER,
Chief Counsel,
Internal Revenue Service.

By: ______________________
THEODORE E. DAVIS
Assistant Regional Counse[l]
26 Federal Plaza, (12th Fl
New York, New York 10007
Tel. No. 212-264-2439.

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D A K COMPANY, INC.

BALANCE SHEET

DECEMBER 31, 1957

ASSETS

CURRENT ASSETS			
Cash on hand and in banks			$ 6,748.61
Prepaid expenses -			
Insurance		$ 687.02	
Interest		724.90	1,411.92
Total current assets			8,160.53
FIXED ASSETS			
Land		5,000.00	
Buildings	$125,000.00		
Furniture and equipment	57,202.34		
Restaurant equipment	18,640.00		
Swimming pool and landscaping	27,428.00		
Automobile	5,483.21		
Total	233,753.55		
Less: Reserve for depreciation	23,842.97	209,910.58	
Fixed assets, depreciated			214,910.58
OTHER ASSETS			
Organizational expenditures-unamortized		798.34	
Utility deposit		225.00	
Total other assets			1,023.34
			$224,094.45

LIABILITIES

CURRENT LIABILITIES		
Notes and contracts payable - due within one year		$ 8,695.45
Mortgage notes payable - due within one year		12,542.52
Accounts payable		6,707.42
State sales tax payable		224.10
Federal income taxes payable		3,119.78
Accrued payroll taxes		2,408.15
Accrued salaries		8,011.00
Total current liabilities		41,708.42
LONG-TERM INDEBTEDNESS		
Notes and contracts payable	$ 11,872.84	
Mortgage notes payable -		
Gulf Life Insurance Company	45,820.89	
H. S. McKinnon	82,640.79	
Total	140,334.52	
Less amount due within one year-above	21,237.97	
Long-term indebtedness		119,096.55
OTHER LIABILITIES		
Notes payable - stockholders	21,104.00	
Accrued interest thereon	1,487.23	22,591.23
Total liabilities		183,396.20

NET WORTH

CAPITAL STOCK		
Authorized and issued 100 shares, no par value	35,000.00	
EARNED SURPLUS		
Net profit for year - EXHIBIT B	5,698.25	
Net worth		40,698.25
		$224,094.45

D A K COMPANY, INC.

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDED DECEMBER 31, 1957

	HOLIDAY RESTAURANT	HOLIDAY MOTEL	TOTAL
INCOME	$70,948.56	$81,808.66	$152,757.22
COST OF SALES	34,094.23		34,094.23
GROSS PROFIT	36,854.33	81,808.66	118,662.99
OPERATING EXPENSES			
Salaries	13,019.04	9,809.39	22,828.43
Depreciation	5,081.27	19,826.44	24,907.71
Supplies	3,437.51	6,020.14	9,457.65
Utilities	2,140.20	6,053.95	8,194.15
Taxes and licenses	1,052.29	2,117.02	3,169.31
Repairs	670.65	4,357.74	5,028.39
Cash short	144.67		144.67
Miscellaneous	114.53	343.02	457.55
Total operating expenses	25,670.86	48,568.31	74,239.17
PROFIT FROM OPERATIONS	$11,183.47	$33,240.35	44,423.82
GENERAL AND ADMINISTRATIVE EXPENSES			
Officers' salaries			10,000.00
Interest expense			9,315.00
Transportation			6,536.79
Advertising			5,185.00
Officers' insurance			1,581.25
Insurance			1,421.03
Auto expense			723.85
Legal and audit			450.00
Amortization of organization expense			109.58
Miscellaneous expense			163.06
Donations			30.00
Total general and administrative expense			35,605.79
NET PROFIT BEFORE FEDERAL INCOME TAXES			8,818.03
FEDERAL INCOME TAXES			3,119.78
NET PROFIT			$ 5,698.25

EXHIBIT B

DAK COMPANY, INC.

BALANCE SHEET

DECEMBER 31, 1963

ASSETS

CURRENT ASSETS			
Cash on hand and in banks			$ 2,958.91
Prepaid interest			618.82
Total current assets			3,577.73
FIXED ASSETS			
Land		$ 5,000.00	
Buildings	$125,000.00		
Furniture and equipment	57,412.94		
Swimming pool and landscaping	27,556.00		
Restaurant equipment	19,029.15		
Total	228,998.09		
Less: Reserve for depreciation	134,400.23	94,597.86	
Fixed assets, depreciated			99,597.86
OTHER ASSETS			
Utility deposits			225.00
			$103,400.59

LIABILITIES

CURRENT LIABILITIES			
Notes payable - due within one year			$ 22,218.26
Accrued property taxes			3,667.86
Accrued payroll taxes			265.79
Accrued interest payable			369.70
State sales tax payable			123.18
Total current liabilities			26,644.79
LONG-TERM LIABILITIES			
Mortgage notes payable -			
Gulf Life Insurance Company		$21,009.43	
H. S. McKinnon		29,575.19	
Note payable -			
State Exchange Bank		4,500.00	
Equipment contracts payable		3,408.02	
Total		58,492.64	
Less: Amount due within one year		22,218.26	
Total long-term liabilities			36,274.38
DUE TO STOCKHOLDERS			45,653.24
Total liabilities			108,572.41

NET WORTH

CAPITAL			
Capital stock - Authorized and outstanding			
100 shares - no par value		35,000.00	
Earned surplus - deficit -			
Balance, January 1, 1963	$39,239.30		
Add: Net loss - EXHIBIT B	932.52		
Balance, December 31, 1963		40,171.82	
Total net worth (deficit)			5,171.82
			$103,400.59

DAK COMPANY, INC.

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDED DECEMBER 31, 1963

	HOLIDAY MOTEL	HOLIDAY RESTAURANT	TOTAL
INCOME	$47,369.89	$14,755.04	$62,124.93
COST OF SALES		7,406.38	7,406.38
GROSS PROFIT	47,369.89	7,348.66	54,718.55
OPERATING EXPENSES			
Salaries	10,445.81	5,755.00	16,200.81
Depreciation	9,719.20	827.83	10,547.03
Utilities	4,739.71	1,396.68	6,136.39
Supplies	3,722.73	489.34	4,212.07
Repairs and maintenance	2,486.61	146.07	2,632.68
Total operating expenses	31,114.06	8,614.92	39,728.98
PROFIT OR LOSS FROM OPERATIONS	$16,255.83	$ 1,266.26	14,989.57
GENERAL AND ADMINISTRATIVE EXPENSE			
Interest expense			6,284.77
Licenses and taxes			4,633.44
Officers' life insurance			1,725.00
Advertising			1,224.38
Insurance			1,072.82
Travel and entertainment			590.94
Auditing			250.00
Miscellaneous			140.74
Total general and administrative expense			15,922.09
NET LOSS			$ 932.52

EXHIBIT B

DAK COMPANY, INC.

BALANCE SHEET

DECEMBER 31, 1964

ASSETS

CURRENT ASSETS			
Cash in banks			$ 2,751.87
Prepaid interest			271.61
Total current assets			3,023.48
FIXED ASSETS			
Land		$ 5,000.00	
Building	$125,000.00		
Furniture and equipment	59,617.75		
Swimming pool & landscaping	27,556.00		
Restaurant equipment	19,029.15		
Total	231,202.90		
Less: Reserve for depreciation	145,562.05	85,640.85	
Fixed assets, depreciated			90,640.85
OTHER ASSETS			
Utility deposits			225.00
			$93,889.33

EXHIBIT A

LIABILITIES

CURRENT LIABILITIES			
Notes payable - due within one year			$10,216.72
Accrued property taxes			3,667.86
Accrued payroll taxes			169.91
State sales tax payable			93.21
Total current liabilities			14,147.70
LONG-TERM LIABILITIES			
Mortgage note payable - State Exchange Bank		$45,310.09	
Note payable - State Exchange Bank		1,839.67	
Equipment contracts payable		1,744.05	
Total		48,893.81	
Less: Amount due within one year - above		10,216.72	
Total long-term liabilities			38,677.09
DUE TO STOCKHOLDERS			49,155.90
Total liabilities			101,980.69

NET WORTH

CAPITAL			
Capital stock - Authorized and outstanding 100 shares - no par value		35,000.00	
Earned surplus - deficit - Balance, January 1, 1964	$40,171.82		
Add: Net loss - EXHIBIT B	2,919.54		
Balance, December 31, 1964		43,091.36	
Total net worth (deficit)			8,091.36
			$93,889.33

DAK COMPANY, INC.

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDED DECEMBER 31, 1964

	HOLIDAY MOTEL	HOLIDAY RESTAURANT	TOTAL
INCOME	$47,251.22	$12,043.76	$59,294.98
COST OF SALES		7,914.52	7,914.52
GROSS PROFIT	47,251.22	4,129.24	51,380.46
OPERATING EXPENSES			
Salaries	9,438.39	3,349.00	12,787.39
Depreciation	10,333.99	827.83	11,161.82
Utilities	5,387.98	1,102.34	6,490.32
Supplies	5,121.58	620.26	5,741.84
Repairs and maintenance	1,887.71	141.78	2,029.49
Total operating expenses	32,169.65	6,041.21	38,210.86
PROFIT OR LOSS FROM OPERATIONS	$15,081.57	$ 1,911.97	13,169.60
GENERAL AND ADMINISTRATIVE EXPENSES			
Interest expense			6,247.60
Advertising			4,908.10
Licenses and taxes			4,465.04
Legal and audit			1,392.05
Insurance			1,314.48
Miscellaneous expense			680.89
Officers' life insurance			431.25
Automobile allowance			336.00
Total general and administrative expenses			19,775.41
NET OPERATING LOSS			6,605.81
OTHER INCOME			
Discount on prepayment of mortgage			3,686.27
NET LOSS			$ 2,919.54

EXHIBIT B

DAK COMPANY, INC.
BALANCE SHEET - DECEMBER 31, 1968
(PREPARED FROM THE BOOKS WITHOUT AUDIT)

Assets

Current assets:		
Cash		$ 51.36
Account receivable - sale of property		500.00
Deposits		225.00
Total assets		$ 776.36

Liabilities and Capital

Current liabilities:		
Accounts payable		$ 1,895.47
Note payable to bank		400.00
		2,295.47
Notes payable to stockholders		50,367.41
Capital:		
Capital stock, authorized and outstanding - 100 shares of no par value	$ 35,000.00	
Retained earnings (deficit)	(86,886.52)	(51,886.52)
Total liabilities and capital		$ 776.36

DAK COMPANY, INC.
STATEMENT OF INCOME AND RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 1968
(PREPARED FROM THE BOOKS WITHOUT AUDIT)

Operating revenue:		
Rental and other income		$ 3,271.77
Operating and general expenses:		
Interest	$ 1,952.89	
Miscellaneous	77.02	
Professional fees	135.00	
Repairs and maintenance	492.75	
Operating supplies and expenses	1,057.54	
Taxes - state corporation	100.00	
Taxes - payroll	24.37	
Taxes - property	2,468.72	
Utilities	302.02	6,610.31
Net loss		(3,338.54)
Special item:		
Loss on sale of real and personal property		(27,840.14)
Net loss and special item		(31,178.68)
Retained earnings (deficit), January 1, 1968		(55,707.84)
Retained earnings (deficit), December 31, 1968		$ (86,886.52)